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Limited Partnerships:

Their Applicability to Small Businesses

- NOTE -

The Small Business Centre is indebted to several legal firms in the Province for their contributions.

This paper has been prepared for information purposes only. It is not meant to be a complete and precise statement of the law as it pertains to limited partnerships.

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INTRODUCTION

Four basic forms of business organization exist. They are

(1) the sole proprietorship,

(2) the partnership,

(3) the co-operative, and

(4) the corporation or limited company.

Each is explained in the Enterprise Manitoba Entrepreneur's Handbook "Forms of Business Organization". Of particular interest here is a specific type of partnership — the limited partnership.

The limited partnership evolved because of the deficiencies, from the investor's point of view, of other forms of business organization. The sole proprietorship does not adequately protect invested capital; the general partnership does not allow limited liability to either the partnership or the individual partners; the co-operative demands active involvement; and the corporation is too restricted. The limited partnership, on the other hand, takes the advantages of other forms and offers an organization that allows some involvement in the business along with certain tax breaks, but with limited liability on the part of the investor.

LIMITED PARTNERSHIP DEFINED

A limited partnership is a business entity with a general partner and one or more limited partners. The general partners manage and control the business and are responsible for all the assets and liabilities. The limited partners are prohibited from active management of the partnership, and therefore, are not liable for debts of the business beyond the amounts of their capital contribution.

Manitoba's Partnership Act defines the constitution of the limited partnership as follows:

> A limited partnership may consist of one or more persons, who shall be called "general partners", and one or more persons who contribute a specific or determinable amount, whether in cash, kind, specie, or money's worth or by any other means whatsoever, as capital of the partnership, who shall be called "limited partners".
> (S.M., 1965, c.59, s.52)

The Act Continues:

> The general partners only are authorized to bind the partnership; but where a limited partner, to the knowledge of the general partners, takes part in the management of the partnership business, he has power to bind the partnership. ... The onus of proof as to knowledge ... is on the general partners.
>
> (Am. S.M., 1965, c.59, s.54)

Thus, the limited partner must be a silent partner" or else he/she loses the protection of the "limited" status and becomes a general partner, with all of the responsibilities and risks inherent in that status. However, the limited partner is entitled to receive reports from the general partner to determine how his investment is being handled, and to ensure it is in accordance with the partnership agreement.

THE NEED FOR LIMITED PARTNERSHIPS

In today's topsy-turvy" financial world of high interest rates, continuing inflation, and recessionary economic conditions, small business is crying out for new "vehicles" to attract equity investment into their operations.

As a result of the need for a small business to offer an investor certain "investment attributes" in structuring an investment proposal, limited partnerships have been looked to increasingly in order to fulfill the following objectives:

(1) Limited liability to the equity investor so that his commercial exposure does not exceed the amount of his agreed investment together with any guarantees that he has agreed to provide in support of the business.

(2) Some degree of control over major business decisions.

(3) Ability of the investor to write-off either or both of:
   (a) a portion of his initial investment due to the use to which the monies are put (such as research and development), or
   (b) the loss of his investment, should the investment go bad, and take such subsequent tax advantage on the respective investor's income tax returns.

(4) Ability of the investor to participate (on a pro rata basis vis-à-vis the investment) in all profits and losses of the limited partnership such that the investor may:

(a) tax shelter or otherwise tax plan his share of profit from the small business investment, and

(b) extract his portion of any cash available out of the business without paying a second level of tax (ie. a dividend tax or the new proposed 12 1/2% corporate distributions tax).

(5) Obtain, where possible, his proportionate share of the small business tax rate available to small businesses in Canada.

FEATURES OF THE ARRANGEMENT

A limited partnership is a "hybrid" of the general partnership which has heretofore been the only partnership used in business or commercial transactions. The hybrid known as a "limited partnership" is created by Provincial Statute in each of the provinces in Canada and is only created (ie. comes into existence) upon the due registration of a limited partnership certificate in the province in which the limited partnership intends to carry on business.

The limited partnership normally will have the following essential features and attributes:

(1) The limited partnership is normally constituted of two types (classes) of partners:

(a) The general partner -

This partner is vicariously (totally) liable and responsible for all debts of the partnership in respect of its percentage interest in the partnership;

(b) The limited partners -

The liability of these partners is limited to the amount of capital they have contributed or agreed to contribute in the original partnership certificate notwithstanding the percentage of the partnership profits they may be entitled to.

Under all of the limited partnership acts in each of the provinces, limited partners, in order to maintain their limited partnership status, must agree to refrain from becoming involved in day to day management and accordingly can only participate in "Major Partnership Decisions".

"Major Partnership Decisions" normally include a number of fundamental business transactions, including:

(i) Dissolution of the partners;

(ii) Admission of new partners;

(iii) Borrowing by the partnership;

(iv) Sale of a major portion of the partnership's assets;

(v) Firing the general partner for cause and replacing him.

(2) The profits and losses are normally allocated in a manner consistent with the following considerations:

(a) Percentage of capital contributed by each of the general partner and the limited partners;

(b) If the general partner has invested a minimal amount of capital, profits and losses may be split more favourably in favour of the limited partners until they have recovered their initial investment and then the percentage of allocation to the general partner may be increased.

(3) As a distinct matter from sharing of profit and losses, cash generated into the limited partnership available for distribution to partners is normally repaid 100% to the limited partners until their capital is recovered and then is allocated on the same basis as the percentage of profits under the partnership agreement.

(4) Title to all the assets of the limited partnership is registered in the name of the general partner as trustee on behalf of all the partners and accordingly all contracts, documents, bank accounts, etc. are normally signed in the following manner:

"X Co. Ltd., as general partner for and on behalf of the XY limited partnership".

(5) A partnership interest of limited partner is somewhat like a share of a capital stock corporation. The partnership interest may be sold, mortgaged, or used as security — just like a share in a corporation.

(6) From a tax point of view, at the end of each fiscal year of the partnership, all profits and losses are then accounted for and computed at the limited partnership level, but the net results are then allocated to each of the limited partners and the general partner based upon their profit and/or loss sharing percentages. Each limited partner and general partner is then required to include in such limited partner or general partner's tax return his share of such year end profits or losses. Accordingly, each partner is able to "tax plan" or "tax shelter" his allocation from the limited partnership based upon such partner's individual tax situation.

(7) From a tax point of view, because profits and losses are deemed to be the income and loss of the partner and are reported as such (even though no cash may be taken out in the case of profits in the year that it becomes taxable), extractions of capital and cash profits can be made tax-free from the limited partnership, thereby avoiding any dividend tax or distributions tax as in the case of investing in a business through a corporation.

(8) In the event that an investor wishes to take advantage of the small business nature of a limited partnership operation, such a limited partner can invest through his own Canadian-controlled private corporation, thereby having that income taxed in the hands of that Canadian-controlled private corporation as small business income.

A brief explanation of "tax shelters" may be in order at this point. A tax shelter is not an avoidance or nullification of tax. A tax shelter is utilized when the earnings of expenses of an operation are treated preferentially through the Income Tax Act and its regulations.

A tax shelter is also a deferment of taxes payable. This deferment can be most beneficial for those taxpayers who can "shelter" taxable income when their income tax rate is high and report the income earned when their income tax rate is low. As an example, Dr. X earns in excess of $50,000 at age 60. "X" buys a limited partnership unit in a business with high research and development write-offs. For the first 2 years these write-offs provide a $10,000 a year reduction of taxable income on "X's" personal tax returns. "X" is in a marginal tax bracket of 50% — ie. for every change in taxable income, tax payable is correspondingly affected 50%. Consequently, "X" pays $5,000 less income tax for each of the two years. "X" then retires. The limited partnership unit yields a profit of $10,000 in the third year and "X's" marginal tax bracket is 30%. The limited partnership unit yields $10,000 in the fourth year and $20,000 in the fifth year. "X's" tax shelter looks like this:

	Write off Profit	Tax Rate	Tax Payable
Year 1	(10,000)	50%	(5,000)
Year 2	(10,000)	50%	(5,000)
Year 3	5,000	30%	1,500
Year 4	10,000	30%	3,000
Year 5	20,000	30%	6,000
	$ 15,000		$ 500

Consequently, the tax shelter showed a net profit position of $15,000 on which only $500 tax was paid; the taxpayer had an additional $10,000 available at retirement date and any future earnings would be subject to the marginal tax rate in effect when the profit is earned.

SUITABILITY

It is important to note that a limited partnership will not always be suitable for every small business investment opportunity due to a number of factors which might include:

(a) inability of the existing business or organization to move its assets into a limited partnership without incurring tax liabilities;

(b) because of the move into a limited partnership, a small business may be required to change its business name thereby causing some costs and dislocation relative to new invoices, stationery, bank accounts, etc.;

(c) the limited partnership format is slightly more complicated than a corporation and, accordingly, there are additional annual legal and accountings costs to maintaining it.

However, if the above factors are not an overriding consideration in rejecting a limited partnership, then the limited partnership will provide to the small business person and the investor the following advantages;

(a) limited liability;

(b) flow-through of the income tax position so as to be able to tax shelter the investor's income or use losses incurred against his/her own personal tax position;

(c) ability to extract cash representing capital or cash surpluses tax-free in the year of extraction;

(d) provide the investor with a limited degree of control by virtue of his/her participation in "fundamental partnership decisions".

(e) ability by investing through a Canadian-controlled private corporation to take advantage of the small business tax rate.

ADVANTAGES FOR THE LIMITED PARTNER

The limited partnership has several appealing characteristics for the potential investor – flexibility, limited liability and tax shelters.

Since the limited partner usually has flexibility in obtaining greater parcels of cash, the limited partnership does not have to get personal guarantees of the investors — which guarantees are usually joint and several (ie. the bank may look only for a guarantee from the most secure of the investors); thus, exposure of the investors is more readily detered. Consequently, (a) the new business is not saddled with a lot of interest costs which could greatly deter the potential of the business venture, and (b) if the limited partner finances the acquisition of the partnership unit, the interest costs can be written off on the limited partner's personal income tax, the result being that less income tax is payable and, in essence, a portion of the interest expense is paid from the money which would otherwise be paid out to income tax.

The limited partnership derives its flexibility from the centralization of control: the general partner alone manages the business and is not encumbered by the need to consult the limited partners in most matters. Thus, the general (and managing) partner is free to respond quickly to charges in the business environment.

Limited liability and the concomittant lower risk factor has definite appeal for many investors. Since the limited partner's liability is restricted to the amount of equity contributed, the financial — and personal — risk involved is far less than it would be were that person a general partner or a sole proprietor.

There are several tax considerations that add to the advantages of the limited partnership. Partners may transfer assets to the business and, in most cases, tax consequences may be deffered. Partners gain certain tax deductions from their investment:

(a) investments in research and development can be written off,

(b) any interest paid on the investment can be written off,

(c) allowable start-up and development costs incurred by the partnership can be written off,

(d) certain ongoing expenses, such as research and development, financing, capital cost allowance, can be written off.

In essence, a portion of the limited partnership investment is paid for by money which would ordinarily be paid to income tax.

Also, losses from the business can be written off against the limited partner's income; such losses are, of course allocated according to the extent of equity contribution or some other pre-arranged agreement. On the other hand, income from the partnership is included in the personal income of each (general and limited) partner.

Limited partners have a stake in the ownership of the business. Their investment increases the equity of the partnership but dilutes the ownership. This is a mixed blessing for general partners: while the inflow of dollars enhances the partnership's financial situation, it decreases the relative strength of the partners. In other words, as the size of the financial pie increases, the percentage represented by each individual's equity contribution decreases. The general partners do, however, retain management control.

If a proper partnership agreement is drawn up at the beginning, a provision might be made for a "roll-over" of the partnership interest into common shares of the business when it is in the best interest of all concerned. Consequently, when the business has reached a solid position and an income tax burden might become harmful for the limited partners, the limited partnership's assets are rolled over into a share capital company, the capital of the limited partnership units is paid back to the limited partners, and the limited partners own a piece of the business for the nominal purchase cost of a share. Other means of drawing out the profits can then best be brought into play, keeping tax planning as a major factor.

DISADVANTAGES FOR THE LIMITED PARTNER

Limited partners have little control in the management of the bsuiness. They may take part only in any "fundamental partnership decisions"; these decisions include resolving the partnership, selling assets, incurring excessive expenses, appointing professional advisors and dismissing senior management.

The disadvantages of the limited partnership for the investor are clearly outnumbered by the advantages of this form of organization.

SUMMARY

Prior to structuring any small business investment proposal, whether it be through a limited partnership or not, the business person should consider the following:

(a) The primary objectives and concerns of the investor.

(b) The degree of equity and control the business person is prepared to give up in order to attract equity investment to the business.

(c) The legal, accounting and commercial problems of restructuring the business into a limited partnership structure.

(d) Concerns that the business banker may have with respect to the restructuring. It is prudent to confirm with the bank that the present security available to the bank can be granted through a limited partnership so as to not upset their banking security.

(e) Obtain the necessary legal and accounting advice (including tax considerations) with respect to any such restructuring and equity investment proposal.

(f) Obtain necessary legal advice with respect to whether or not solication of investors to make an equity investment in the business requires any registration or exemption from any applicable securities legislation in force.

(g) Having a proper partnership agreement in place for a potential "roll-over" into a corporation once the business is on a solid footing and tax sheltering of income and investment write-offs are no longer beneficial to the limited partners.